Fédération Bancaire Européenne
European Banking Federation
Le Secrétaire Général

UW/GM
Letter n°0454

E-mail

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Brussels, 23 June 2006

Subject: **CP 11 – Technical aspects of the management of interest rate risk arising from non-trading activities and concentration risk under the Supervisory Review Process**

Dear Mrs Nouy,

The European Banking Federation (FBE) welcomes the opportunity to respond to CEBS' CP 11 on the management of interest rate risk and concentration risk. We support CEBS' efforts to promote a common approach towards the application of the Supervisory Review Process. However, we would like to voice our concerns on the timing as well as the substance of especially the second part of the proposed guidelines.

Given the overlap with the questionnaire on Large Exposures (LE) we believe that from a procedural point of view CEBS should defer any further work on concentration risk until the responses to the LE questionnaire have been analysed. In addition, banks are of the view that the concentration risk guidelines as they stand now are in many aspects over-prescriptive and not in line with industry practices. We expect that a careful consideration of current industry standards will allow CEBS to make a more realistic and principles-based proposal.

However, we also believe that the guidelines on IRRBB need some streamlining to avoid undue interference with firms' internal management strategies and to ensure that the further development of these strategies is not hampered.

Please find our elaborated response enclosed. For any questions, please don't hesitate to contact either myself or my colleague Uta Wassmuth (u.wassmuth@fbe.be).

Yours sincerely,

Guido Ravoet

Enclosure: 1

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Response
CP11 – Technical aspects of the management of interest rate risk arising from non-trading activities and concentration risk under the supervisory review process

General comments

1. The European Banking Federation (FBE) welcomes the opportunity to respond to the additional technical guidance proposed by CEBS on the application of the Supervisory Review Process. The second Pillar plays a key role in the new Basel II rules. However, it is a potential source of significant divergence in the treatment of individual institutions. CEBS' initiative of providing a common understanding of key aspects treated under Pillar 2 is therefore appreciated.

2. At the same time, the industry is concerned by the overlap of the consultation paper with other CEBS work streams, in particular the questionnaire on Large Exposures and the guidelines on stress testing. Given the interdependencies of these aspects, care must be taken to ensure a coherent approach that refrains from interfering with banks' internal management strategies.

3. We commend CEBS for its recognition of current market practices on IRRBB. This is a useful starting point, from which the first part of the consultation paper has clearly benefited.

4. We regret however that this exercise has not been repeated in the second part of the paper on concentration risk. Many of the questions posed in the questionnaire concern basic aspects of concentration risk. The responses provided by institutions to these questions should inform the supervisory guidance. We therefore call on CEBS to delay any additional work on concentration risk until the stock take on Large Exposures has been carried out.

5. On the basis of a sufficient analysis and evaluation of the responses given to the Large Exposures questionnaire, the second part of CP 11 should be carefully reconsidered. As they stand now, CEBS' draft guidelines are in many aspects overly prescriptive. We believe that it is too early to provide detailed guidelines. The current proposals risk hampering the further development of best practices. We expect that the findings on current industry practices will allow CEBS to make a more streamlined and principles-based proposal.

6. We underline that the calculation of economic capital under Pillar 2 lies in the full responsibility of the financial institution. The supervisory role should to the greatest extent possible be exercised in the form of a dialogue with the institution, rather than through detailed written regulation. Guidelines must therefore be provided at a high, principles-based level. As it currently stands, also the part on IRRBB is in some instances too detailed. This leads

furthermore to a potential overlap with other CEBS guidelines which have an impact on the calculation of own funds.

7. Importantly, to deliver an accurate picture the SRP must also take account of banks' mitigation strategies. In particular diversification as the flipside of concentration should be given stronger consideration.

8. Stress testing of IRRBB and with regard to concentration risk has to be seen in the context of the global picture of stress-testing as treated in CEBS' CP 12. We therefore suggest treating all aspects of stress testing under CP 12 only, and to delete any reference to stress testing from CP 11.

9. We request CEBS to explicitly recognise that most banking groups manage both IRRBB and concentration risk at group level. Importantly, a group might have a particular interest rate risk or risk concentrations at the level of the legal entity which are meaningless when the risk portfolio of the institution as a whole is considered.

Specific comments

Part 1: the Interest Rate Risk in the Banking Book

10. The management of interest rate risk has to be seen in the context of banks' general risk management practices. CEBS' guidance should therefore leave sufficient scope for banks' internal approaches and allow for interest rate risk management to be built on the same internal methodologies that underlie it. To make this even clearer we would suggest that IRRBB 4 be turned into IRRBB 1.

11. Along a similar line, guidelines for stress testing should be based on the recognition of the function that stress testing has for banks. Managing risks and taking strategic risk positions is part of the core business of financial institutions, and stress testing is used as a management tool. The general assumption of risk management is a situation of "going concern". We suggest that this be clarified by CEBS, in particular as regards paragraph 18.

12. As a result, stress testing considers an institution's ability to absorb losses through its normal earnings. Rather than to explore the limits of banks' shock absorption capacity it should be based on significant but plausible assumptions, defined by the institution itself. Scenarios set up by supervisors risk becoming too prescriptive and ignoring institutions' particularities, which the management is best placed to understand. We believe that CEBS should clarify that banks only resort to economic capital where this is unavoidable, i.e. on exceptional occasions. In the great majority of cases losses are covered by the regular income. We therefore disagree with CEBS' assessment in paragraph 6 of Part 1 that "measurement of the impact (of interest rate risk) on economic value provides a more comprehensive view of the potential long-term effects on an institution's overall exposures". This scenario is not typical, and it provides a static situation, rather than a more holistic picture over a statistically relevant period of time.

13. However, we believe that, in order to avoid overlap and to provide clarity in its guidelines, all provisions on stress testing should be tackled in CP 12 only, and should be deleted from CP 11.

14. Regulatory requirements should only have regard to the total available capital and to the total capital requirements, whereby diversification effects are taken into account in the determination of the latter. There should be no regulatory requirements under Pillar 2 for specific risk categories.

15. We also wish to stress that banks use a wide range of tools to manage IRRBB. The proposed guidelines lay too much stress, in our view, on capital add-ons. We call on CEBS to clarify that capital is only the last of a number of possible measures.

16. With regard to IRRBB 1, we note that where economic capital requirements are calculated at the group level, calculations at the solo entity level do not deliver meaningful results. Importantly, they disregard diversification effects, whereby risks of individual legal entities are offset against each other. The diversifications between, *inter alia*, different currencies and legal entities play an important role. These effects should be taken into account both as part of the risk management and under Pillar 2 in the discussion between the bank and its supervisor regarding the bank's economic models.

17. Concerning IRRBB 3, we believe that institutions should be allowed to use their own estimates when calculating their sensitivities to changes in the yield curve or changes between different market rates, as well as regarding customer behaviour. Banks should also be allowed to base these estimates, where appropriate, on local parameters. At the moment, banking groups often experience that local parameters are not recognised by their home supervisor. However, every market segment has its own characteristics. Preventing groups from taking this into account has adverse consequences on financial stability. We encourage the supervisors to increase their cooperation with a view to overcoming this regulatory impediment to good risk management.

18. Whilst we agree in principle with IRRBB 4, experience shows that lists such as the one provided here are often misused and can become a "tick-box exercise". To allow for flexibility and adjustments of institutions' policies, we suggest that CEBS concentrate on the principle itself. The list should at least be considerably shortened to illustrate more clearly that it is up to the institution to put its own policies in place and, if necessary, adapt it to changing circumstances going forward.

19. On IRRBB 5, we strongly support CEBS' effort to provide a common understanding of the characteristics of a standard shock. We consider a truly common supervisory approach crucial in this regard. However, the precise calculation of a standard shock is subject to several sometimes fast changing parameters. The proposed guidelines are therefore perceived as too detailed and should be streamlined.

20. Instead, we would encourage CEBS to agree on a common approach to the standard shock by way of intensive and ongoing cooperation on the working

level. This is particularly important for home and host supervisors of the same banking group, and we believe that this should be more clearly reflected in CEBS' wording in the last bullet point. Indeed, in order to increase the commonalities in practice we suggest that supervisors agree through ongoing cooperation in the framework of CEBS on standard shocks by currency. For example, a single standard shock should be used for the Euro-zone.

21. Whilst we appreciate IRRBB 9 in principle we underline that it should in the first place be up to the institution to take corrective action when this seems necessary. Regulatory intervention should be the exception. However, we believe that not only the relative decline but also the net value of the loan portfolio be taken into account for the assessment of the interest rate risk. A positive economic value of the banking book is the best protection against an interest rate risk shock.

Part 2: Concentration risk

22. Whilst we agree that concentration risk is an issue that must be given careful consideration, we point out that the responsibility for managing it must clearly remain with the institution. We consider that CEBS' proposed guidelines are too far-reaching and detailed to leave sufficient scope for institutions' own practices. In addition, measurement systems for concentration risk are in quite early stages and will be further developed. Institutions' research and learning process should not be hampered by rigid supervisory requirements.

23. Given the current standards, the proposed provisions are in a number of cases too ambitious or in other aspects not in line with market practices. For example, Concentration 2 requests the existence of internal systems that combine several categories of concentration risk, as well as the CRM techniques. This does not correspond to the actual design of institutions' risk management systems, and it also goes beyond the requirements set out in the CRD.

24. Furthermore, we are not convinced that concentration risk should be measured in the same way as credit risk, and the answer to this should not be given through regulatory intervention. For example, concentration risk must be defined against a certain reference pool. We would not agree that this pool be determined through regulation.

25. In the light of these open questions we request CEBS, again, to avoid providing too many examples. The list given e.g. under Concentration 3 applies to some banks but will in many other cases not be applicable and might render the dialogue with their supervisors more difficult for institutions.

26. We welcome CEBS' acknowledgement that diversification is the obverse to concentration. However, we would encourage CEBS to be more explicit on the relationship between concentration and diversification in the principles themselves.

27. We do not agree with Concentration 5. Concentration risk is implicitly taken into account in the measurement of economic capital, i.e. there should be no

separate capital requirements under Pillar 2. We also reiterate that risks should not only be assessed against concentrations, but also taking into account diversification.

28. In our view, Concentration 8 contains again too many examples. In addition, the proposed indicators can be misleading. Many institutions are specialised by economic sectors or by type of activities, but they may be widely diversified within this range of activities. Banks should therefore identify on an individual basis specific sectors that are particularly sensitive to them, and which should consequently be in the focus of the SRP.

29. We find the term “limit” misleading. Institutions define indeed maximum concentrations of risk acceptable to them. However, these depend on a number of factors that might be subject to regular adaptations. We would suggest to use the term “areas of concern” to appropriately designate this.

30. In addition, we would appreciate clarification on whether the figures of these areas of concern should be measured nominally, or should be risk-weighted.